BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

[Redacted]In the Matter of the Protest of)
) DOCKET NO. 17221
[Redacted]) DECISION
)
Petitioner.)
)

On January 15, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (hereinafter referred to collectively as "taxpayer"), asserting additional corporate income taxes, penalty and interest in the amount of $355,902 for the 1999 and 2000 taxable years. On March 17, 2003, the taxpayer filed a timely appeal and petition for redetermination. An informal hearing was held at the Boise office of the Idaho State Tax Commission on June 17, 2003. The Tax Commission, having reviewed the file, hereby issues its decision.

FACTS

[Redacted] filed Idaho combined corporate income tax returns for the 1999 and 2000 taxable years on a worldwide combination basis. Included within the 1999 and 2000 combined group was [Redacted], which is a holding company created in 1998 as part of a restructuring of the [Redacted] business segment. [Redacted] owns a 56% interest in [Redacted], which is a joint venture between [Redacted] and [Redacted]. According to the [Redacted] [Redacted], "[Redacted]

- [Redacted]) is a [Redacted] limited liability company that conducts business within Idaho. It has elected under Internal Revenue Code § 7701 and related Treasury Regulations to be taxed as a partnership. As a result, [Redacted] filed federal and Idaho partnership tax returns for 1999 and 2000. On its 1999 Idaho partnership return [Redacted] reported net business income subject to apportionment of $334,942,447, and an Idaho apportionment factor of 0.3475%, resulting in net business income apportionable to Idaho of $1,163,925. On its 2000 Idaho partnership return [Redacted] reported net business income subject to apportionment of $413,021,842, and an Idaho apportionment factor of 0.2967%, resulting in net business income apportionable to Idaho of $1,225,436. That net business income apportionable to Idaho was then passed through to the owners in proportion to their profit sharing percentages. [Redacted]1999 $651,798 [$1,163,925 x 56%]

- 2000 $686,244 [$1,225,436 x 56%]

This income was then included as part of the net business income subject to apportionment on the taxpayer's ([Redacted]) Idaho combined corporate income tax returns for 1999 and 2000 respectively. However, none of the [Redacted]apportionment factors associated with the generation of that income (i.e., the Idaho payroll, property and sales used to generate the income) were included in the taxpayer's Idaho apportionment factor computation, resulting in the dilution of the Idaho apportionable business income that had been passed through to [Redacted]. In other words, the Idaho apportionable income passed through from [Redacted] was included in the net apportionable income of the combined group and apportioned once again using the apportionment factors of just the members of the combined group, which did not include any of the Idaho payroll, property or sales of [Redacted]

[Redacted] is a holding company (as opposed to an operating company) and, outside of [Redacted] of [Redacted], it conducts no business within Idaho or elsewhere. [Redacted] is, however, a member of the unitary group of companies that filed as part of the 1999 and 2000 combined group. Thus, the apportionable business income of [Redacted] is included in the Idaho combined group report, and its total payroll, property and sales are included as part of the combined group's denominators in the apportionment factor calculation. Except as discussed below, [Redacted] had no payroll, property or sales that were included in the Idaho numerator of the apportionment factor calculation.

The taxpayer's 1999 and 2000 Idaho combined corporate income tax returns were selected for audit. Among the audit adjustments made to the taxpayer's 1999 and 2000 Idaho returns was [Redacted] [Redacted]. In other words, the Idaho apportionment factor for [Redacted] was increased by including in the numerator of the factor calculations [Redacted] on its 1999 and 2000 Idaho partnership returns.[1]

In its letter of protest, the taxpayer objects to the audit adjustment made to flow-through the Idaho attributes of [Redacted] into the numerator of the [Redacted] apportionment factor calculation. According to the taxpayer's representative, "[t]he auditor erroneously attributed the factors of [Redacted]to [Redacted]], and then included [Redacted]'s factors in both the numerator and denominator of the . . . group's apportionment formula. This had the effect of taxing [Redacted]. Taxpayer contends that taxing [Redacted] is not authorized by Idaho's tax statutes and, moreover, flies in the face of the Due Process and Commerce Clauses of the U.S. Constitution." Letter of protest, p. 3. Thus, the taxpayer is challenging the audit adjustment made to the apportionment factor of [Redacted] on both statutory and constitutional grounds. The taxpayer has also requested that the Commission abate the 10% substantial understatement penalty. This Decision will address each of these issues in turn.

ANALYSIS

[1] There were other audit adjustments made to the taxpayer's 1999 and 2000 Idaho consolidated corporate income tax returns. However, none of those other audit adjustments have been protested.

A. The Audit Adjustment Was Proper Under the Idaho Income Tax Statutes and Administrative Rules.

The first issue to be addressed is whether the audit adjustment described above was proper as a matter of statutory law. The Commission finds that it was. Idaho Code § 63-3006A provides that a limited liability company "shall be classified as a partnership, corporation, unincorporated association or otherwise pursuant to the provisions of the internal revenue code." That section goes on to provide that "[a] limited liability company that is classified as a partnership pursuant to the internal revenue code shall be treated as a partnership for purposes of" the Idaho income tax statutes. Likewise, a limited liability company that is classified as a corporation pursuant to the Internal Revenue Code is classified and treated as a corporation for purposes of the Idaho income tax statutes.

Both [Redacted] and [Redacted] are limited liability companies. [Redacted] has elected to be treated as a partnership under the provisions of the IRC, while [Redacted]has elected to be treated as a corporation. Thus, for Idaho income tax purposes, this protest involves a corporation ([Redacted]) that is a member of a partnership ([Redacted]) that is conducting business within this state.

Because [Redacted] is treated as a corporate partner in [Redacted] the factor attribution rules set out in Idaho Income Tax Administrative Rule 620 control. That Administrative Rules provides in relevant part as follows:

> **620. ATTRIBUTING INCOME OF CORPORATIONS THAT ARE MEMBERS OF PARTNERSHIPS (Rule 620).**
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> **01. In General.** If a corporation required to file an Idaho income tax return is a member of an operating partnership, the corporation shall report its Idaho taxable income, including its share of income from the partnership, in accordance with this rule. . . . .
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> . . . .
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> **04. Partnership Income As Business Income Of The Partner.**
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> a. Income. If the income or loss of a partnership is business income or loss to a corporate partner, its share of this net business income or loss shall be apportioned together with the other net business income or loss of the corporation. . . . .
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> b. Factors. <u>A corporate partner's share of the partnership property, payroll, and sales after intercompany eliminations, shall be included in the numerators and the denominators of the partner's property, payroll, and sales factors when computing its apportionment formula.</u> The partner's share of the partnership's property, payroll, and sales is determined by attributing the partnership's property, payroll, and sales to

> the partner in the same proportion as its distributive share of partnership income if reporting net income for the taxpayer year or in the same proportion as its distributive share of partnership losses if reporting a net loss for the taxable year. . . .

IDAPA 35.01.01.620 (2002). (Emphasis added).

In the present case, the Tax Commission's audit staff correctly applied the factor allocation rule set out in Rule 620.04.b. The taxpayer's claim that the audit adjustment was invalid as a matter of statutory law is simply incorrect.

B. The Taxpayer Has Not Established any Constitutional Violation.

The second issue to be addressed in this administrative protest is whether attributing the distributive share of [Redacted]'s payroll, property, and sales to [Redacted] results in the taxation of [Redacted] in a manner that is inconsistent with the Due Process Clause or Commerce Clause of the U.S. Constitution. More specifically, the taxpayer asserts that [Redacted]has insufficient nexus with Idaho to be subject to Idaho's income tax. According to the taxpayer's representative, "[t]he only way Idaho can reach [Redacted]is by imputing the contacts of [Redacted]. Thus, the issue is whether the contacts of [Redacted]should be attributed to [Redacted]." Letter of protest, p. 3.

There is no dispute as to the fact that [Redacted] does business in Idaho, and during the years at issue earned net business income apportionable to Idaho in the amounts of $1,163,925 and $1,225,436 respectively. It is also undisputed that [Redacted] [Redacted]. It should also be undisputed that the state of Idaho is constitutionally permitted to tax the income earned by [Redacted] from its Idaho business activities. The question, then, is whether the method Idaho has chosen to tax that income (i.e., taxing it at the corporate partner level by attributing the income and the factors to the partner) is unconstitutional under the Due Process Clause or the Commerce Clause.

As a threshold matter, it should be noted that a party challenging the constitutionality of a state tax bears the heavy burden of proving that the tax is unconstitutional. With respect to the Due Process clause, the taxpayer must demonstrate either that there is no minimum connection between the interstate activity and the taxing state, or that there is no "rational relationship between the income attributed to the State and the intrastate values of the enterprise." Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 219 - 220, 100 S.Ct. 2109, 2118 (1980) (*quoting* Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436 - 437, 100 S.Ct. 1223, 1231 (1980)). Under the first part of the Due Process test, sufficient connection (nexus) is created if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum state. Quill Corporation v. North Dakota, 504 U.S. 298, 307, 112 S.Ct. 1904, 1910 (1992). Additionally, a state's apportionment formula will normally meet this second part of the two-part Due Process test unless the taxpayer can establish that the formula attributes income to the taxing state that is "out of all appropriate proportion to the business transacted by the [taxpayer] in that State." Id. (quoting, Hans Rees' Sons v. No. Carolina, 283 U.S. 123, 135, 51 S.Ct. 385, 389 (1931)). Stated another way, "the taxpayer always has the distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed." Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 175, 103 S.Ct. 2933, 2945 (1983) (internal quotations omitted). See also Butler Bros. v. McColgan, 315 U.S. 501, 507, 62 S.Ct. 701, 704 (1942) ("One who attacks a formula of apportionment carries a distinct burden of showing by clear and cogent evidence that it results in extraterritorial values being taxed.") (Internal quotations omitted.); Moorman Mfg. Co. v. Bair, 437 U.S. 267, 274, 98 S.Ct. 2340, 2345 (1978) ("States have wide latitude in the selection of apportionment formulas and . . . a formula-produced assessment will only be disturbed when the taxpayer has proved by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted in that State, . . . or has led to a grossly distorted result.") (Internal quotations omitted.).

Under the dormant Commerce Clause, the taxpayer must demonstrate that the state tax "(1) applies to an activity lacking in substantial nexus to the taxing State; (2) is not fairly apportioned; (3) discriminates against interstate commerce; *or* (4) is not fairly related to the services provided by the State." Barclays Bank PLC v. Franchise Tax Bd. of Cal., 512 U.S. 298, 310 - 311, 114 S.Ct. 2268, 2276 (1994) (citing, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079 (1977)). Again, the burden of proof when challenging a state tax statute on dormant Commerce Clause ground is clearly on the taxpayer. See, e.g. Trinova Corp. v. Michigan Dept. of Treasury, 498 U.S. 358, 111 S.Ct. 818 (1991) (holding that Trinova failed to establish that the Michigan tax was not fairly apportioned or that it discriminated against interstate commerce.)

Applying these principles to the present case, the Tax Commission does not believe that the taxpayer has established any Due Process or Commerce Clause violation. The taxpayer does correctly point out that [Redacted]is a limited liability company and not a partnership, and that as a limited liability company it is a distinct legal entity from [Redacted]. From this initial premise, the taxpayer asserts that "[i]n this regard, it is firmly established that a business entity is not subject to the taxing jurisdiction of a State if its only nexus with the State is ownership in a separate business entity." Letter of protest, p. 3 (citing 12 cases in support). The taxpayer goes on to state that "[Redacted]'s only connection with Idaho is its passive investment in [Redacted]," Id. at p. 4, and that "[u]nder the U.S. Constitution, a member of an LLC is not subject to Idaho corporate excise tax if its only connection with Idaho is the interest in an LLC." Id. at p. 5. The Tax Commission does not agree.

The United States Supreme Court has held that a state may obtain jurisdiction to tax income as a result of the relationship between the state and (1) the person being taxed, (2) the property creating the income, or (3) the business activity or transaction creating the income. Shaffer v. Carter, 252 U.S. 37, 52, 40 S.Ct. 221, 225 (1920) ("[J]ust as a State may impose general income taxes upon its own citizens and residents whose persons are subject to its control, it may . . . levy a duty of like character . . . upon income accruing to non-residents from their property or business within the State, or their occupations carried on therein; enforcing payment, so far as it can, by exercise of a just control over persons and property within its borders.") (Emphasis added). In International Harvester Co. v. Wisconsin Dept. of Tax'n, 322 U.S. 435, 64 S.Ct. 1060 (1944), the U.S. Supreme Court further expounded on this issue of income tax nexus resulting from the ownership of a business entity that is conducting business in the taxing state. According to the Court in International Harvester:

> For the reasons stated in [State of Wisconsin v. J. C. Penney Co.] we do not doubt that a state has constitutional power to make a levy upon a corporation, measured by so much of its earnings from within the state as it distributes in dividends, and to make the taxable event the corporation's relinquishment of the earnings to its stockholders. . . .
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> . . . .
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> The power to tax the corporation's earnings includes the power to postpone the tax until the distribution of those earnings, and to measure it by the amounts distributed. In taxing such distributions, Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholder-taxpayer is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to

> events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. And the privilege of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.
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> We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders. It has afforded protection and benefits to appellant's corporate activities and transactions within the state. These activities have given rise to the dividend income of appellants' stockholders and this income fairly measures the benefits they have derived from these Wisconsin activities.

Id. at 441 – 442, 64 S.Ct. at 1063 – 1064 (emphasis added).

Consistent with the Due Process Clause of the United States Constitution, a state may tax nonresident individuals and businesses on income derived from business activity taking place within the state and distributed to the nonresident shareholders or owners of that business. Whether that income is distributed in the form of dividends or, as in the present case, in the form of a "pass-through" distribution, is without any Constitutional significance. It is well-established that a business or individual that owns an interest in a pass-through entity such as a Subchapter S corporation will normally be considered to have nexus for income tax purposes in those states in which the S-Corporation is conducting its business. See, e.g. Kulick v. Dept. of Revenue, 624 P.2d 93 (Or. 1981); Agley v. Tracy, 719 N.E.2d 951 (Ohio 1999); Valentino v. Franchise Tax Board, 105 Cal. Rptr. 2d 304, 311 n. 11 (Cal. Ct. App. 2001). C.f. Richards v. Idaho State Tax Com'n, 131 Idaho 476, 959 P.2d 457 (1998) (Although no constitutional issue raised, the Idaho Supreme Court held that nonresident shareholder of a S-Corporation doing business in Idaho was subject to Idaho tax on a portion of the interest income he received from loans made to the S-Corporation.). In short, it is a recognized principle of constitutional law that the ownership of a pass-through business entity is sufficient to give the owner nexus for income tax purposes in those states where the pass-through entity conducts its business. We see no reason why the form of the pass-through business entity (partnership, S-corporation, limited liability company) should make any difference in Idaho's ability to tax the owner on the income derived from the entity's Idaho activities.

Additionally, the Commission is not convinced that [Redacted] ownership interest in [Redacted] amounts to simply owning a passive interest in a company doing business in Idaho. It is true that [Redacted] [Redacted] [Redacted], and [Redacted] [Redacted] [Redacted]. However, it is equally apparent that [Redacted], [Redacted] [Redacted]:
[Redacted], [Redacted]).

[Redacted]. We see no reason why a corporate member of an [Redacted]should be insulated from complying with Idaho's income tax laws simply because that member chose to conduct its in-state business through the use of a limited liability company.

In any event, the specific issue raised in this administrative protest is an issue of first impression in Idaho. Limited liability companies are a relatively new type of business entity, and it appears that there are no cases that have analyzed whether ownership in a LLC, or the receipt of pass-through income from an LLC, is sufficient to create nexus for a corporate member. Absent clear authority on point establishing a constitutional violation, the Idaho State Tax Commission is constrained to apply the tax laws of this state as written. The audit adjustments were correct under Idaho's income tax statutes and administrative rules, and the taxpayer has not demonstrated any clear constitutional infirmity with the factor attribution rules set out in Income Tax Administrative Rule 620.04.b.

C. The Substantial Understatement Penalty Should Be Waived.

The final issue to be addressed in this administrative protest is whether the 10% substantial understatement penalty should be waived. The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that "[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." I.C. § 63-3046(d)(7). The Commission finds that given the lack of any clear authority on point relating to the constitutional issue discussed above, there was reasonable cause for the understatement in this case. The Commission also finds that the taxpayer has acted in good faith, and that waiver of the entire understatement penalty is appropriate.

WHEREFORE, the Notice of Deficiency Determination dated January 15, 2003, is MODIFIED in accordance with the foregoing analysis, and as so Modified is hereby APPROVED, AFFIRMED AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following taxes, penalty and interest:

YEAR	TAX	PENALTY	INTEREST	TOTAL
1999	$116,406	-0-	$28,139	$144,545
2000	162,608	-0-	26,361	188,969
		TOTAL		$333,514

Interest is calculated through September 15, 2003, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this ______ day of ____________________, 2003.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that I have on this ____ day of ______________________, 2003, served a copy of the within and Decision by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

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COMMISSIONER